DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 07-0078
Individual Income Tax
For the Years 2001, 2002, 2003, and 2004

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. **Individual Adjusted Gross Income Tax –** Imposition.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; 26 U.S.C.A. § 62.

Taxpayer protests the imposition of Indiana income tax for 2001 and 2002 based on BIA assessments arguing that Taxpayer did not reside in Indiana and had no Indiana source income for those years.

Taxpayer protests the imposition of Indiana income tax for 2003 and 2004 based on BIA assessments with proof of actual income earned from Indiana sources for those years.

II. **Tax Administration** - One-Hundred Percent Fraud Penalty.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-10-4; IC § 6-8.1-10-2.1; 45 IAC15-11-4; 45 IAC 15-5-7; 45 IAC 15-11-2.

Taxpayer protests the imposition of the one-hundred percent fraud penalty.

STATEMENT OF FACTS

For the years at issue, Taxpayer was the sole owner and shareholder of two Indiana restaurants (Corporation A and Corporation B). The Indiana Department of State Revenue (Department) audited Corporation A and Corporation B in 2005/2006 for the years 2003 and 2004. During the audit, an investigation noted that the sole owner of the businesses had not filed Indiana individual income tax returns. The Department assessed individual income taxes on Taxpayer for the years 2001 through 2004. The Department further assessed a one-hundred percent fraud penalty on Taxpayer.

Corporation A was started in March 2001. Taxpayer is the only responsible officer listed with the Department. Corporation A ceased operation in December 2004. For 2001 and 2002, Corporation A filed IT-20SC income tax returns. For 2003, Corporation A filed an

IT-20 income tax return. At the time of the audit, Corporation A's 2004 income tax return was not on file. Since no income tax returns or records were made available for review during the audit, the Department had to estimate wages that would have been paid to Taxpayer during the years in question. The Department estimated net income based on the "best information available" (BIA) by utilizing BizStats.com, a web site that has average profitability and expense percentages for U.S. small businesses in several categories. Total revenue reported to the Department on the monthly sales tax returns for the years 2001 through 2004 were used as the total revenue figure. A series of calculations based on those figures ultimately arrive at net income. Taxpayer was assessed individual income tax based on the net income for these years.

Corporation B was started in August 2003. Again, Taxpayer is the only responsible officer listed with the Department. At the time of the 2005/2006 audit, Corporation B was still in operation and had not filed any corporate income tax returns. Sub Chapter S returns were prepared in a separate investigation and the results of that investigation were carried to Taxpayer's investigation, as income to Taxpayer.

A hearing was held with Taxpayer and his representative. This Letter of Findings results. Additional facts will be provided as necessary.

I. Individual Adjusted Gross Income Tax – Imposition.

DISCUSSION

Indiana imposes an adjusted gross income tax on the adjusted gross income of Indiana residents. IC § 6-3-2-1(a). Indiana adjusted gross income is calculated by starting with the federal adjusted gross income and making certain modifications. IC § 6-3-1-3.5**(**a). The federal adjusted gross income calculation begins with the inclusion of all of the taxpayers' income. 26 U.S.C.A. § 62.

Notices of proposed assessments are prima facie evidence that the Department's claim for unpaid taxes is valid. The Taxpayer has the burden of proving that the Department incorrectly imposed the assessment. IC § 6-8.1-5-1(b). Taxpayers are required to keep adequate books and records so that the Department can determine the proper tax owed to the state. IC § 6-8.1-5-4. IC 6-8.1-5-1(a) states that "If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the *best information available*." (*Emphasis added*).

Taxpayer had not timely filed his Indiana income tax returns. After the Department's investigation concluded, Taxpayer provided his state and federal income tax returns to the Department in the course of his protest. In preparation for and after the Department's hearing, Taxpayer provided documentation relating to his residency, as well as records for both Corporation A and Corporation B.

2001 and 2002 – income from Corporation A

For 2001 and 2002, Taxpayer claimed he was a resident of New York and had no W-2 income from Corporation A. Corporation B was not in existence in 2001 and 2002.

Taxpayer provided substantive evidence that he resided in New York in 2001 and 2002, including employer statements, utility bills, etc. Taxpayer further provided Corporation A's W-2 and W-3 forms as filed with the Social Security Administration for both years to prove that he did not earn any wages from Corporation A in 2001 or 2002. Furthermore, Corporation A paid no dividends in 2001 or 2002 per Forms 1120 and IT-20SC (filed in 2002 and 2003 respectively).

2003 – income from Corporation A and Corporation B

For 2003, Taxpayer agreed that he was a resident of Indiana for part of the year. Taxpayer argued that he should be assessed income tax only on a total of three-thousand dollars ($3,000) of income from Corporation A and Corporation B.

Taxpayer became an Indiana resident in July 2003. Corporation B was formed in August 2003. The Department carried income from Corporation B to Taxpayer on the basis of Sub Chapter S returns that were prepared as part of a separate investigation. Taxpayer argued that Corporation B never requested S corporation status from the Internal Revenue Service. Taxpayer provided W-2 and W-3 forms for Corporation A and Corporation B for 2003 as filed with the Social Security Administration. These forms show that Taxpayer earned one-thousand-five-hundred dollars ($1,500) from each of Corporation A and Corporation B, for a total of three-thousand dollars ($3,000). Neither Corporation A nor Corporation B paid dividends in 2003 per Forms 1120 and IT-20SC.

2004 – income from Corporation A and Corporation B

For 2004, Taxpayer agreed that he was a resident of Indiana for that year. Taxpayer argued that he should be assessed income tax only on six-thousand dollars ($6,000) of income from Corporation B.

The Department carried income from Corporation B to Taxpayer on the basis of Sub Chapter S returns that were prepared as part of a separate investigation. Taxpayer argued that Corporation B never requested S corporation status from the Internal Revenue Service. Corporation A had losses in 2004. Taxpayer provided W-2 and W-3 forms for Corporation A and Corporation B as filed with the Social Security Administration for 2003. These forms show that Taxpayer earned nothing from Corporation A and six-thousand dollars ($6,000) from Corporation B. Neither Corporation A nor Corporation B paid dividends in 2004 per Forms 1120 and IT-20.

Taxpayer has met his burden of proof to overcome the BIA assessments for the years 2001, 2002, 2003, and 2004. Taxpayer, however, will owe Indiana income tax for 2003 and 2004 based on actual income earned from Indiana sources.

FINDING

Taxpayer is sustained on his protest of assessment of income tax based on the BIA numbers. Taxpayer, however, will owe Indiana income tax based on actual income earned from Indiana sources.

II. Tax Administration - One-Hundred Percent Fraud Penalty.

DISCUSSION

The Department assessed a one-hundred percent fraud penalty against Taxpayer on the basis that: Taxpayer failed to file Indiana income tax returns and correctly report information to the Department; had previous knowledge of the requirement to file income tax returns and was on notice from both the Department's examiner and his tax preparer of this requirement; that this kept the Department from even knowing he could have an individual income tax liability thus deceiving the Department; a deception upon which the Department relied and which kept it from collecting taxes due and owing to the State.

Taxpayer protests the assessment of this penalty, but has not specified the grounds for the protest other than that the BIA assessments were incorrect. Generally, Taxpayer would bear the burden of disproving an assessment. IC § 6-8.1-5-1(b). However, to be liable for the civil fraud penalty, a taxpayer must have failed to file a return, or failed to pay in full the tax reported on any filed return *with the fraudulent intent of evading the tax*. *The Department is required to show by "clear and convincing" evidence that Taxpayer intended to defraud the State of Indiana of monies owed to it.* Because of the Department's burden to show by clear and convincing evidence that Taxpayer intended to defraud the State, this Letter addresses Taxpayer's incomplete statement of this protest.

IC § 6-8.1-10-4 states:

> (a) If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty.
> (b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100%) multiplied by:
> (1) the full amount of the tax, if the person failed to file a return; or
> (2) the amount of the tax that is not paid, if the person failed to pay the full amount of the tax.
> (c) In addition to the civil penalty imposed under this section, a person who knowingly fails to file a return with the department or fails to pay the tax due under IC 6-6-5 or IC 6-6-5.5 commits a Class A misdemeanor.
> (d) The penalty imposed under this section is imposed in place of and not in addition to the penalty imposed under section 2.1 of this chapter.

45 IAC 15-11-4 is one of IC § 6-8.1-10-4's implementing regulations:

> The penalty for failure to file a return or to make full payment with that return with the fraudulent intent of evading the tax is one hundred percent (100%) of the tax owing. Fraudulent intent encompasses the making of a misrepresentation of a material fact (See 45 IAC 15-5-7(f)(3)) which is known (See 45 IAC 15-5-7(f)(3)(B)) to be false, or believed not to be true, in order to evade taxes. Negligence, whether slight or great, is not equivalent to the intent required. An act is fraudulent if it is an actual, intentional wrongdoing, and the intent required is the specific purpose of evading tax believed to be owing.

Title 45 IAC 15-5-7(f)(3) lists and describes the elements applicable to fraudulent failure to file a return (45 IAC 15-11-4 does so for fraudulently made tax underpayments). 45 IAC 15-5-7(f)(3) states:

> A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.
> (A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the department's regulations. Any failure to correctly report such information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.
> (B) Scienter: This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.
> (C) Deception: Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the department to believe a given set of facts which are not true, the person has deceived the department.
> (D) Reliance: Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the department to rely on these acts to the detriment or injury of the department, the reliance requirement of fraud will be met.
> (E) Injury: The fraud instituted upon the department must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the department not to have collected the money which properly belongs to the state of Indiana.
> In order to demonstrate fraud, the department is required to prove all of the above elements are present. This must be shown by clear and convincing evidence.

The Department has not shown with "clear and convincing" evidence that Taxpayer intended to defraud the State of Indiana of tax owed and due to it. The fact that Taxpayer knew of his duty to file income tax returns and remit any taxes owed the State does not equate to an intent to defraud the State. To wit, IC § 6-8.1-10-2.1(a)(1) assesses a ten-percent negligence penalty against a taxpayer who fails to file a tax return even when presumably the taxpayer knows of their duty to pay a listed tax. Therefore, mere knowledge of one's duty to file taxes is not enough. More clear and convincing evidence is required to show that Taxpayer not only knew of his duties, but intended to defraud the Department.

However, Taxpayer was certainly negligent. Under IC § 6-8.1-10-2.1 "[n]egligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." 45 IAC 15-11-2(b). Thus, negligence requires the person penalized to have a less guilty (and more common) mental state than, and does not require proof of, intent to defraud.

The Department refers to IC § 6-8.1-10-2.1 and to 45 IAC 15-11-2(b), the latter of which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Thus, negligence does not require intent to defraud. However, absence of intent to defraud is not the same as proof that a taxpayer had reasonable cause for failing to meet its compliance responsibilities. The taxpayer has failed to submit any evidence showing, or make any argument, that he had reasonable cause for failing to file Indiana 2003 and 2004 Indiana income tax returns in a timely fashion. As a matter of fact, Taxpayer did not file these returns until mid-2006, around the same time the Department made its BIA and fraud penalty assessments. This pattern of late filings is also evident with

Corporation A and Corporation B, of which Taxpayer is the sole listed responsible officer.

Taxpayer was grossly negligent in not filing his Indiana income tax returns in timely fashion. While Taxpayer skirted the one-hundred percent fraud penalty, Taxpayer will be assessed the ten-percent penalty for negligence.

FINDING

Taxpayer's protest of the one-hundred percent fraud penalty is sustained. Taxpayer, will, however, be assessed a ten-percent negligence penalty.

LS/WL/DK – December 3, 2007